

# The European Central Bank: A Full-Fledged Scheme or Just a "Fledgeling"? \*

## 1. Introduction

Whatever future awaits the European Central Bank (ECB), no-one is allowed to forget that its consecration took place at Maastricht. This was the end of a long process of technical, economic, diplomatic and political discussion, set off systematically and decisively by the Delors Report, but which goes back as far as the 1971 Werner Report and to the ideas of Jean Monnet. It would be of great intellectual interest to go through all the various stages of this evolution, including the experience of the EMS which in its thirteen years of life has made many people have second thoughts about the validity of a system of fixed, but adjustable, exchange rates; however, today's challenge is to look forwards, to achieve a Europe of new dimensions, to understand what the future holds in store. One good sign is the speed which took us from Hanover, where the Delors Group was given its mandate, to Maastricht, where the articles providing for, *inter alia*, the creation and the workings of the new institution were definitively agreed by the governments of the Community for onward transmission to their parliaments.

The history of central banks is distinguished more by a pragmatic evolution in reply to, or in anticipation of, markets' movements or behaviour than by legislative acts; the latter, however, not only constitute the juridical base for central banks' activity, but from time to time also the turning points in their evolutionary path. Even

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though praxis is a determining factor in monetary control, it is nevertheless necessary to study what type of institution the founding fathers had in mind, and whether it has linearity, solidity and completeness, characteristics which make one hope for a good beginning and a successful development of the ECB. The search for the above-mentioned characteristics can be made by tracing the institutional model and the cultural influence which inspired the constitution of the Monetary Union in the articles of the Treaty and Protocols which contain the Statute of the ECB and the European System of Central Banks (ESBC), the provisions for the European Monetary Institute (EMI), the criteria for convergence, and the procedure regarding excessive deficits.

To perform such an operation, it is unnecessary to have participated in the preparatory works, with which the author was however associated till the end of 1990; attentive reading of the texts suffices to realise that the institutional model is the Bundesbank and that the dominant cultural influence is monetarism, even though of a version acceptable to a large part of the economic profession. The merits and the limits of the model highlighted by the German experience, particularly recent, and the advantages and disadvantages which can result over time from the choice of a precise theoretical approach, even though not particularly restrictive, should allow one to judge whether the structure of the Monetary Union has those characteristics of linearity, solidity and completeness which would make it credibly stable, or whether it should evolve by means also of international legislative acts. It is more difficult to say which direction the evolution will take, since it is frankly premature to put forward hypotheses on the relative strength of the many economic interests, political groups and cultural models.

This analysis will refer to the decision-making structure of the future central bank (Section 2), to its independence (Section 3), to the objectives to be met in deciding and carrying out monetary policy (Section 4), to the exercise of certain functions, especially the banking ones which are ancillary to the former, and also present in independent central banks (Section 5). Some conclusions, not by any means definitive, again take up the themes of the institutional model and cultural influence (Section 6). Finally, a postil (Section 7) makes a few remarks on the convergence required if Italy is to reach, together with the other Community countries, the craved for Third Phase in which the monetary souls or currencies will reach the Nirvana of the single unit and in it self-destruct.

## 2. The Decision-Making Organs

In every institution the decision-making structure is to a large extent responsible for the fulfilment of its mandate and for the effectiveness of its actions; the European Central Bank cannot be the exception to this simple rule, so it is worth starting with some comments on the decision-making mechanisms which are planned. According to Article 9 of the Statute, two decision-making organs will preside over the fate of the ECB: the Governing Council and the Executive Board. The latter consists of the President, the Vice-President and four other members, all appointed by common accord of the member states at the head of state or government level, on the recommendation of the Council (of Ministers) and after consultation of the European Parliament and the Governing Council, all taken from people whose professional authority and experience in the monetary and banking fields are well-known. Their mandate lasts eight years and is not renewable. Each member of the Executive Board present at the sitting has the right to one vote. The said Board is responsible for the day-to-day management of the ECB (Article 11 of the Statute).

The Governing Council consists of members of the Executive Board and of the Governors of the national central banks. Except for particular specified cases, each member has one vote. Decisions are taken by simple majority, and in case of deadlock the President has the casting vote (Article 10 of the Statute).

At first sight, there are a number of similarities between the ECB and the Bundesbank, if one compares their decision-making structures. In both cases, the Council of the central bank defines monetary policy, whose execution is delegated to the Board; the latter may number up to ten members in the Bundesbank. The Councils of the two institutions include the members of the Board and the presidents of the national central banks or of the Länder, respectively.

Can it be said that the ECB is a replica of the Bundesbank? Credit can certainly be given to such an argument, even though some differences seem to emerge from the analysis of the instruments at the disposal of the two institutions (Fratianne-von Hagen-Waller, 1992). To the extent to which it is a replica, it is to be hoped that the positive aspects of the German experience can transmigrate into the ECB, but it is also inevitable that the latter will come up against the

same type of problems that the Bundesbank has had to tackle. Above all, the drawbacks that the latter has met and is still trying to overcome with respect to relations between the Executive Board, more sensitive to international requests and responsibilities, and the Council, more inclined to listen to the demands which come from the heart of the country, risk replicating themselves, perhaps changed in dimension, in those between the Executive Board and the Governing Council of the ECB. In addition, the increase in the number of Länder following German unification has worsened the problem, which had already arisen, of the relationship between the number of members of the Board and that of the Council inside the Bundesbank. The attempt to try to modify the rule which gives each Land the right to send the president of its "central bank" to the Council was stranded in the federal parliament; the aim of President Pöhl, before resigning his position, was to reduce the number of bankers representing the Länder to seven or eight. Negotiations are under way to settle for nine and finally award representation in the Council to the five new "states" which have come into being with the disappearance of the German Democratic Republic.

The solution which is chosen in Germany will have to be carefully studied, since it may represent a precedent for the ECB, because of the resemblance between the decision-making structures of the two institutions. Within a few years, most probably before the transition to the Third Phase and the constitution of the ECB, a certain number of countries will be admitted to the European Community. Obviously, this refers to Austria, Sweden, Finland, Malta, Cyprus, Turkey, perhaps Norway and even Switzerland. One must also not forget that countries such as Hungary, Poland and Czechoslovakia have also publicly announced their intention to join the Community. Thus, also in the Council of the ECB, probably from the beginning, there will be problems of equilibrium between members of the Executive Board and members of the Council, aggravated by the principle of one, equal vote for everyone in the latter. The arithmetic would probably be ever more in favour of the Governors of the central banks, which will include a number of heads of those of small countries.

The democratic principle of "one man (or woman), one vote" was preferred to a weighted voting system in order to avoid each Governor behaving, and being considered as, a representative of his country. However, this mechanism has the seeds of an evil which

could lead to a crisis. Will there be a need to resort to a system of "constituencies" in which the small banks unite and express their one vote through a common representative? If this is not politically acceptable, will more power need to be given to the Executive Board, for example by doubling the number of votes at the disposal of each member? In this way, however, the weighted vote is reintroduced, following the opposite path to that envisaged by the Statute for questions relating to capital subscription, transfer of foreign reserve assets, and profits distribution. This problem has an important political dimension, but above all a fundamental relevance for the conduct of monetary policy; as soon as the Community begins to accept new members again, it will come up rather seriously, and the way it is resolved will influence the interpretation of the mandate and, above all, its fulfilment.

### 3. The Independence of the European Central Bank

It is time to tackle the fundamental subject of the future monetary regime of the Union, the independence of the ECB, which definitely constitutes its principal characteristic. According to Article 107 of the Treaty and Article 7 of the Statute, neither the ECB, nor a national central bank, nor any other decision-making organ or component of such can accept or solicit instructions from organs or institutions, be they Community or national. In addition, Article 108 of the Treaty and Article 14.1 of the Statute provide that each member state will render its national legislation compatible, including the statute of the central bank, with the provisions of the Treaty and of the Statute of the European System of Central Banks. Article 14.2 decrees that the mandate of a central bank Governor cannot last less than five years and that its incumbent cannot be removed, except in cases of serious fault or if he no longer satisfies the conditions necessary for the exercise of his functions. Finally, in order to avoid a conflict of interests, thus making this independence effective, Article 104.1 of the Treaty and Article 21 of the Statute specify that the ECB, like the national central banks, is forbidden from giving any type of credit to the institutions or organs of the Community, to the central or local administrations, to other public authorities, organs or

companies of the member states, as well as from buying any government securities on the primary stock markets.

These were the texts agreed at Maastricht. We cannot but ask ourselves: why is independence deemed necessary and, above all, to what end? Independence from political power is an age-old request of central banks, possibly insisted upon too much by those who claim it, which does not lack for explanations. One may assume that central bankers are unanimously in favour of it, even when the national regime of dependence on the Treasury renders their declarations on the subject somewhat guarded; indeed, either they know from experience the political constraints to which they are subject in their daily work, or – as some malicious observer might say – they want to affirm their prestige and complete a process which has made them powerful over the last two centuries, above all after gold ceased to exercise a direct influence on money supply. And in the evolution of the institutions it is fatal for “independence” to become a request which crowns and consolidates the newly acquired position by the recognition of a status which effects the separation from the age-old “protector”, in this case the Treasury.

Indeed, there is no lack of theories which wish to separate the currency from the state, as was forcefully maintained by von Hayek (1976), or at least money from political influence, as asserted by Barro and Gordon (1983). The latter start with the assumption that the population abhors inflation and unemployment, whereas the government is able to vary the level of unemployment in the short term, by unexpected changes in monetary policy, taking advantage of the imperfect flexibility of prices and salaries. Obviously, the cost to pay is higher inflation. Also, due to the continuous “blackmail” of elections, governments – an expression of the dominant class which wishes to retain power – have a necessarily reduced time horizon; even were it infinite, the economic calculation might lead them to choose inflation. The public, however, who have learned by experience, will end by not reacting positively to monetary injections, so production will not increase and only inflation will remain. In order to break the vicious circle, the government could promise to pursue a policy of stability, but it would not be fully believed, since it would always have an interest in reneging its pledge. The only solution, therefore, is that of abandoning the monetary lever in favour of an “independent” agency obliged by law to pursue the stability objective.

One arrives at similar conclusions following a line of juridical-economic reasoning – in Italy, Monti (Ministero del Tesoro, 1982) was one such strenuous defender with reference to direct controls on credit and on foreign exchange – which can be summarised in the following terms: inflation is a form of taxation not only particularly odious, blind in its redistributive capacity and inefficient in that of stimulating a long-lasting resumption of activity, but also removed from the authority of parliaments which, in the constitutions of this millennium, have retained tax-collecting power. If monetary policy is in the hands of the government, it will be inclined to use inflation as a method of taxation, by-passing legislative power. A less scholastic vision of the separation of powers, and the way to implement it, leads to similar results: parliament, also subjected to the encumbrance of re-election, tolerates, if not hopes for, the use of the monetary lever, since that will allow it to avoid imposing taxes to finance the budget. Obviously, inflation will materialise only later, giving the temporary benefit of a higher level of activity and employment now. Therefore, since the Statute of the ESCB and the ECB was written by the central bank Governors of the Community, it is to be presumed that they have transferred their experiences and convictions, so that the link between independence of the central bank and the objective of stability would seem to have a good basis both in theory and in practice.

Can one therefore take it that the Maastricht Treaty has put an end to inflation and to political interference in monetary management? If it were true, it would be wonderful! Economic reality, however, cannot be radically changed by a legal text, even one ennobled by the skill of those who wrote it and made venerable by the ratification of the European and national parliaments. Indeed, there are those who make a fundamental distinction between the independence of the central bank and the credibility of its monetary policy; in the varied relationships between central banks and Treasuries both in the Community and in other Western countries, there are monetary authorities subject to the directives of the Treasury with a good record in the fight against inflation, and other relatively independent ones who have achieved worse results. However, there seems to be some empirical evidence to support the assumption that links good results in the fight against inflation to independence (Grilli-Masciandaro-Tabellini, 1991, amongst others).



The correlation might be of a spurious type, either because the indicators for measuring independence reveal little, or because the incidence of other variables (attitude of fiscal policy, frequency and nature of shocks, etc.) are not analysed; this again brings up the reasons of those who see credibility as the main foundation of the effectiveness of a central bank in its anti-inflationary stance. Credibility is a function of behaviour which includes declarations of intent, although it does not end there; in other words, it is a result of the consequentiality between forecasts, announcements, monitoring of the indicators and manoeuvring of the instrumental variables. Obviously, this deviates from Barro and Gordon, according to whom a rule of economic policy can be rendered credible by the reputation of the policy maker only if its violation determines a cost, due to loss of credibility, which is greater than the gain expected by the breaking of the rule.

This attempt to reduce all behaviour to an economic calculation makes one lose sight of the ethical-political basis of the need for reputation, and therefore becomes artificial. For example, to state that most men do not steal for fear of prison is too simplistic to render the complexity of the motives which govern action; where the precept "do not steal" does not form part of the collective conscience, such as for tax avoidance in Italy, fear of handcuffs or prison is not a social deterrent (Roncaglia-Sylos Labini, 1990). Thus, consistent behaviour over a sufficient time arc forms the basis of a reputation, and this in turn renders the actions of the central bank credible and predictable, thus stabilising market expectations.

If this view is accepted – in essence, it is difficult to refute – there is an initial problem for the ESCB and the ECB at the start of the Third Phase: how can a new institution earn itself a good reputation, and rapidly? There seem to be only two ways, on which it is worth lingering briefly.

The first is for the ECB to be perceived as the scion of the most credible of the national central banks which will form the ESCB, and not as the son of all the latter's participating institutions – this is why the Bundesbank wants to base the ECB in Frankfurt, but it is unlikely that such a strategic decision would be taken merely on the basis of such considerations. Anyway, the choice of the ECB head office will have to be made by the end of 1992 (Article 37 of the Statute). Had it been politically acceptable, a message of continuity in reputation and credibility could have come from the choice of the Deutsche Mark as

the monetary unit of the Economic and Monetary Union (EMU). Indeed, the maximisation of such an effect of continuity would have been achieved with the extension of the jurisdiction of the central bank which has had most success in the fight against inflation. This has been possible in the process of the monetary and political unification of Germany, but it would have been absolutely impossible in the context of the European Union.

The other way is that of using the period of transition, the Second Phase, to acquire a minimal reputation which could be transformed into credibility for the ESCB and the ECB in the Third Phase. Indeed, the European Monetary Institute (EMI) has the task of contributing to the fulfilment of the necessary conditions for the transition to the Third Phase of the Economic and Monetary Union, particularly by reinforcing the coordination of monetary policies with the aim of ensuring the stability of prices, etc. (Article 2 of the Statute of the EMI). However, this refers to an organ without real power, only slightly different to its predecessors, the Committee of Governors and the EMCF. Only the wish to prepare adequately the functioning of the common monetary policy could push the central banks which make up the EMI to give it a much higher content of coordination in its actions. Do not forget that it is based only on the agreed wishes of the participants, since transferrals of monetary sovereignty are excluded in the Second Phase.

A great chance of making the coordination effective would be a pledge not to realign the parities in the EMS during the Second Phase; monetary policies could not diverge since there would no longer be the possibility of adjusting the exchange rates, whereas it is highly likely that the central bank with the best anti-inflationary record will end up by leading all the others along its path of monetary expansion. This is why one should not be in favour of a "final realignment" by fixing a conversion rate in the transition to the single currency which is different from the central rate in force at the time (Giovannini, 1991). Apart from burdening the birth of monetary unification with a sort of "original sin", it would remove a strong, maybe the only, incentive to co-ordinate monetary policies in the Second Phase. Would all this not entail an advance of the Third Phase which requires as a necessary and sufficient condition the irrevocable fixing of the exchange rates, not the introduction of the single currency which is the coronation of monetary union? Indeed yes, and this is another reason (Sarcinelli, 1991a) in favour of a short

Second Phase, shorter than that presently provided for by Article 109J of the Treaty. If coordination of national monetary policies were not more incisive than in the recent past, and between now and the end of 1994 there were one or more realignments, absent from the European scene since 1987, the only alternative would be that of a particularly rigid monetary policy in the first phase of operation of the ECB in order to build the reputation needed to constitute a capital of credibility in successive decades. If this is clear enough to the leaders of European monetary policy, the Second Phase could be, even in its brevity, of great help in preparing a suitable environment for an easy transition to the final phase.

Apart from its relationship with credibility and reputation, the independence of the ECB takes on importance as a social value. The independence enjoyed by some central banks both in Community and non-European contexts, instead of being the magnanimous renunciation of enlightened political classes, could be – and in some cases is – the expression of the particularly hostile feeling of the electorate about the instability of the monetary unit. In such a case, the different preference for this value, instead of creating a united front among the voters in the Community, would contribute to maintaining, and perhaps worsening, divisions which are present today, but are seen as less conflicting since institutions and policies in each country express and modulate them.

It has been correctly stated (Goodhart, 1991) that conceding independence to the ESCB will not take money away from politics, but will contribute more to politicising the institution and its every action. As has been said on other occasions (Sarcinelli, 1991b), historically, currency has never managed to remain separate from politics, and there is very little likelihood of success in the future. Even the Bundesbank is seen by German economists (Neumann, 1991) to be a political animal, not in the slightest a stranger to the fight for power which it exercises by pursuing the objective of stability. If the attitude of the countries of the Union towards the fight against inflation is not homogeneous, the division of the ESCB Governors when voting in the Council cannot but become in the long term a reflection of the social preferences of their respective countries. The consequence might be a fairly stable polarisation in the Council of groups of Governors, a systematic conflict between one or more of these groups and the members of the Executive Board nominated by the heads of state or government, a Council majority which is less sensitive to the stability of the

monetary unit, as the Community is enlarged to include countries which will constitute the less-developed periphery. Precisely in order to avoid national connotations, the Treaty took up the indications given from the beginning by the Delors Report, and successively confirmed by the Monetary Committee and the Committee of Governors, to assign to each member (Governor or Executive Board component) a vote in monetary policy decisions; the resort to a weighted vote with nil weight for Board members is only provided for, as already said, for subjects in which the division of the ECB subscribed capital is important. It has been asserted that if there is asymmetry in national credibility, the attribution of votes should also be asymmetrical and orientated in favour of countries with low inflation (Casella, 1991). One cannot deny that the argument is elegant, but the cure would be worse than the illness since it is definitely not by systematic discrimination, presumably fixed once and for all in an international treaty, that we will construct a community of equals in rights and responsibilities, as are all secular and democratic communities. The European Union does not require – and one hopes it will not require – uniformity of cultures or, for lack of it, their hierarchical ranking. The process of the formation of social values must remain free to move in a very wide spectrum.

Concluding on this point, independence, credibility, reputation of the ECB and the ESCB, as well as the asymmetrical attitude of the various countries towards monetary stability, are anything but completely defined concepts or processes: only experience will tell us if and how they will evolve under the pressure of the forces in favour of the Union, of those which are more luke-warm to the process of European integration, of events of often differing impact which will accompany the entire process.

#### 4. The Monetary Function

It is worth taking a look at the monetary function that the ESCB and its central motor, the ECB, are called to undertake. The objectives that the Treaty and the Statute both lay down are the following: *a)* to maintain price stability; *b)* without prejudice for the preceding, to support the general economic policy of the Community; *c)* to act in

conformity with the principle of an open market economy in which there is free competition (Article 105 of the Treaty and Article 2 of the Statute). The author is convinced, based also on the discussions in which he took part in the Community context till the end of 1990, that the real objective is only the first, *a*). Indeed, that indicated as *b*) specifies that the other objectives listed in Article 2 of the Treaty are to be maintained only if they do not conflict with price stability. Thus, no trade-off is possible, except for interpretations which seem to be supported neither by the letter, nor by the spirit, nor even less by the many preparatory studies. This conforms to the principle of responsibility in a democratic society which requires that the Government be directly accountable to Parliament and then to the electorate for the political actions which it effects, in particular, through the choice and weighting of the objectives. The conformity to this model derives precisely from the assignment to the ESCB by the Community law of a single objective, from which the "agent" cannot depart. In other words, the monetary function from distinctly political becomes apparently technical. If this framework seems to provide an organic rationalization for the independence of the central bank from the Executive, one should not forget what has already been stated: in substance, politics will re-emerge through the actions and in the life of the institution.

Finally, the objective given as *c*) is technically a constraint: it merely specifies that the single, real objective must be pursued by instruments consistent with the logic of an open and competitive market economy. Does this signify that compulsory reserves and direct controls are excluded? For the former, the reply is negative, since it is specifically provided for in Article 19 of the Statute; as for the latter, it seems positive. It is true that Article 20 of the Statute provides that with a two-thirds majority of the votes cast, the resort to other operative methods of monetary control can be decided, but it adds that Article 2, which lists precisely the aforementioned objectives, has to be upheld. However, some doubt still remains since the next paragraph of Article 20 specifies that if such methods result in obligation for third parties, the procedure envisaged by Article 42 is to be applied. However, even were direct controls allowed with the precautions of the votes and procedures already noted, it would not follow that *c*) above would reacquire its value as an objective; it would also lose its constraint characteristic and would be reduced to a mere restatement of principles without operative validity.

Given that there is a single objective, can it be striven for directly, without interference or conditioning by other policy makers and, were it unambiguously defined in the texts, could its non attainment entail some form of "sanction"? It is worth examining each of these aspects separately.

#### 4.1 *The Price Stability Objective*

There is no indication in the Treaty as to what price index must be taken as a basis for reference for monetary policy; this will certainly not be the most complex operation, even if the homogenisation of the structure or contents of the national consumer price indices (but what of the weights?), the possible removal of indirect taxes, etc., entail a task of patient linking-up with the institutes of statistics, including that of the Community. If they do not opt for a new, single index, valid for the whole Community, they will have to weight the national ones. Once we have a consistent and trustworthy meter of the success of monetary policy at our disposal, the task has only just started.

The measurement of the final objective tells us nothing about the *modus operandi* of the common monetary policy. Article 12.1 of the Statute states only that, depending on the case, the Governing Council decides on the intermediate monetary objectives, the key interest rates and the supply of reserves. After the breakdown of the Bretton Woods system, the central bank is thought to aim at controlling the growth of money supply; since the Seventies, targeting has proved to be an efficient technique, easily understood by economic and financial agents, capable of rendering credible the actions of the central bank that adhered to it. But liberalisation and deregulation of the financial markets have made the distinction between money and other financial assets weaker and weaker. Not only is there ever more uncertainty about the M on which one should rely; even the periodic revision of the chosen M seems ever less convincing. The identification of the statistical aggregate now seems ever more problematic, and will become even more elusive in an environment that will continue to integrate and lend itself to ever greater financial innovations in the Single Market. Indeed, the M selected must not only have a stable relationship with the nominal GDP, which is precisely what is lacking, but its growth must be

controllable by interest rates: financial innovation has made all previous relationships unstable (Lamfalussy, 1992, amongst others). It has been announced that the Bundesbank is in agreement with the Federal Government to reinforce the financial markets in Germany, but against the introduction of money market funds, since that would weaken its monetary control.

Is it possible that the ECB, despite the strong influence of the Bundesbank, would wish to renounce the guiding role of monetary aggregates and take refuge in step-by-step management of the current economic and monetary situation? Most likely, the reply would be negative because of the number and seriousness of the mistakes which can be committed thus; because of the loss of the mechanism which, by allowing the agents to judge the actions of the central bank on the basis of pre-announced intermediate objectives, allows the development of its reputation and credibility; finally, because of the greater difficulty for the central bank to justify the variations in the interest rates on the basis of general economic considerations, instead of the movement of the pre-selected aggregate (Lamfalussy, 1992). All these forces which act on money demand and on the functions of monetary control are present more in the Anglo-saxon world than in the continental one, but they have a tendency with time to enter into less innovative systems, as we have seen.

On the other hand, the success of monetary policy in Europe was also due to adhesion to the narrow band of the EMS by a large majority of the Community countries, which resulted in the choice of the exchange rate as the operating objective. When the ESCB and the ECB start functioning this possibility will disappear for all the countries which will participate in the Third Phase.

#### 4.2 *The Constraints in Pursuing Price Stability*

Could one say that the ECB will not suffer conditioning by other policy makers in the pursuit of the price stability objective? Were the budget policy of the Community to become very expansionist, for example, the ECB could oppose a monetary policy aimed at reducing the growth of GNP, on the basis of the second of the objectives listed in both the Treaty and the Statute, only if price stability were in danger. Obviously, inflationary effects can be expected and forecast differently by fiscal and monetary authorities, resulting in some sort of confron-

tation. Even though such an eventuality cannot be excluded, the probability that it would become an open conflict seems very low. It is more likely that the fiscal authority of one or more countries would decide to increase the budget deficit; in this case, there would be more chance of controversy than risk for the policy of monetary stability.

The provisions of Article 109.1 of the Treaty could constitute a serious danger in conferring on the Council (of Ministers) the power to undertake formal agreements by unanimous decision on an exchange rate system between the ECU and non-Community currencies, and even more so those of Article 109.2 which allows the Council (of Ministers) to decide by a qualified majority on the formulation of general guidelines for the exchange rate policy *vis-à-vis* non-Community currencies, in the absence of an exchange rate system. If this reaffirmation of the pre-eminence of political power in the area of foreign relations were really exercised by adhering to a fixed system of exchange rates, *ex hypothesi* against the opinion of the ECB, the ability of the latter to stem the effects of imported inflation by letting the ECU appreciate would disappear and would be jeopardized if the ECB received instructions which partially limited its freedom of action. The first hypothesis appears remote in view of the scarce interest in radical modification of the international monetary system (Triffin, 1991); as for the second, it is likely that the declaration of intents will remain as such, since it is unthinkable that constraining instructions could be imposed on the ECB against its wishes, as is also stipulated by the Treaty.

#### 4.3 *Sanctions for Failing to Achieve Price Stability*

Finally, can some sort of sanction be imposed if price stability is not achieved? First, it must be noted that there is no quantitative definition of stability: must the price variation be absolutely nil? If the reply were affirmative, one would at least need to establish up to which decimal point! And if it were negative, it would be worth indicating the interval in which, given the difficulties of a precise statistical survey of prices and the presence of not only seasonal but also cyclical movements, one could say that the objective of stability has been achieved; furthermore, it would be necessary to decide if excessive increases in one period, presumably a year, could be offset in the following interval(s).



Goodhart (1991) has stressed that in New Zealand the Government signed a contract with the Governor of the Reserve Bank, according to which the latter entered into an engagement to limit the price increases to between zero and two per cent in the corrected retail price index. The obvious consequence is that if the Governor fails by the end of 1993 (initially 1992) to achieve this result, his appointment is not renewed. In view of the poor conditions of the state of the art of monetary control, such contracts are comparable to those that medieval monarchs imposed on unfortunate astrologers and alchemists, guilty in the royal opinion of not having conjured up the desired astral conjunction or the coveted transformation of base metal into gold! It would be inadvisable to lay down some sort of sanctionary mechanism; that which naturally prejudices professional prestige as a result of failure is enough. If repeated year after year, lack of success could not but lead to the resignation of the person(s) in charge of the ECB.

More perplexing is the lack of any indication of a quantitative norm, which implies that the specific objective will be decided by the very organ which has the duty of carrying it out. Could there not be a conflict of interests? The insufficient definition of the objective corresponds to its lack of modification over time, as though the present conditions could be extrapolated *ad infinitum*. For example, it is inconceivable that the objective of price stability as defined (*rectius*: definable) for normal conditions could also be applicable in times of war, insurrection or financial crash. Some sort of mechanism for suspension of the rule seems preferable, and less damaging to the confidence of financial agents and the institution's reputation, to a self-justification blaming the difficulties of the time.

## 5. The Banking Functions

Historical evolution has led to the reduction in the relative importance of some central bank functions, and to the increase of others. Indeed, the banking role of the central institutions has become intellectually secondary to the monetary one (Folkerts Landau-Garber, 1991), although it has not disappeared; furthermore, at least one function, crossing the borders of moral suasion, has taken

on a clear and explicit connotation of administrative regulation, as is the case of banking supervision. Among the banking functions no longer in the foreground are those of lender of last resort and of guarantor of the proper working of the payments system; even though somewhat linked by their common roots, they are logically distinct. Therefore, with reference to the ESCB, it will be examined in detail whether and what role is attributed by the Treaty and the Statute to the lender of last resort, the guarantor of the payments system, and the banking supervisor.

### 5.1 *The Lender of Last Resort*

In the Statute of the ECB and the ESCB there is no such expression as "credit of last resort", neither is the ESCB ever referred to as creditor of this type. The credit operations are mentioned in Article 18 of the Statute, which states that in order to pursue the objectives (Article 2) and to carry out the fundamental tasks (Article 3) of the ESCB, the ECB and the national central banks can, as well as intervening on financial markets, perform credit operations in favour of credit institutions and other market agents, with an adequate collateral, on the basis of general principles defined by the ECB, including the statement of the conditions in which the national central banks are prepared to carry out such operations.

Could one assert, on the basis of what has been related, that the most well-known function of a central bank since Bagehot's time has disappeared from the monetary scene of the Europe of the future? The reply is questionable, to say the least, and anyway complex. Differentiating ordinary and extraordinary, macro- and micro-economic, credit of last resort (CLR) (Ripa di Meana-Sarcinelli, 1990), extraordinary macroeconomic CLR can already be excluded as inadmissible. It is resorted to in cases of generalised crisis which often originate on the stock markets; however, we have seen that the only real objective of the ESCB is price stability and that there exists no mechanism to declare its suspension in financial crises. Except resorting to an *ad hoc* redefinition of the objective, the possibility of action by monetary policy should wait for the crash to provoke a recession and perhaps a depression, with a fall in absolute product prices. In this case, however, there is no need for CLR, but only to increase the rate at which the money supply was meant to grow, in order to compensate for the reduced velocity of circulation.

Extraordinary microeconomic CLR, about which several criteria have been proposed (Ripa di Meana-Sarcinelli, 1990), is used to save a bank or a financial firm in the case of incipient or manifest incapacity to honour its obligations, in particular when its fall would entail a systematic risk. It is a questionable case which could be included or excluded from the operative area of national central banks by the directive which the ECB is required to issue. A slender hope of making the scales fall on the side of admissibility seems, with much good will, inferable from the requirement that collateral must be adequate, not that it must be sufficient to repay the loan. In theory, and sometimes in practice, for credit of last resort, the value of the collateral is not always the most important variable.

We are left with ordinary CLR, which is responsible for defending the power of money to circulate and thereby the mechanisms which ensure a fluid and secure payments system; indeed, since the access to credit of last resort at the central bank is usually *condicio sine qua non* for full participation in the final settlement between financial institutions, the criteria for admissibility to benefit from ordinary CLR, which have to be defined by the ECB, should coincide with the requisites for admission to the more sensitive area of the payments system, where the final accounts are settled. Since one of the fundamental tasks of the ESCB is to ensure the correct working of the payments system, ordinary credit of last resort would seem to be definitely admissible and should not have to be subjected to overly-restrictive interpretation (see Article 22 of the Statute). However, as Italian experience shows, ordinary CLR is easily substituted by operations on the open market, unless the money market is highly segmented. In any case, coordination between the ECB and the national central banks is required for the management of the CLR, in order not to give conflicting monetary policy signals; furthermore, its granting should be assigned almost totally to the national central banks, while the effects on the monetary base could be sterilised by the ECB, if necessary.

### 5.2 *The Guarantor of the Payments System*

The two principles – that the ECB and the national central banks can undertake credit operations, and that one of the ESCB's fundamental tasks is the advancement of the payments system – are

not, however, enough to establish the direction in which the Community will wish to move in this area; the characteristics of the payments system, in turn, will contribute to defining to what extent ordinary, as well as extraordinary, CLR will be necessary for its efficient working. It is worth noting that Article 22 of the Statute provides that the ECB and the national central banks may grant credit facilities, and the ECB can also lay down regulations.

The "wholesale" payments system, according to Folkerts Landau and Garber (1991), depends on the degree of securitisation of the financial system, which leads to a greater development of the markets than of the banking institutions. The higher the degree of securitisation of credits, property rights and derived contracts, the larger and more flexible must be the safety net which guarantees liquidity, which can be supplied to the agents only by the banks and in the last instance by the central bank. It must not be forgotten that the characteristics of stock dealers are low capitalisation and high leverage, which leave them highly exposed to the risk of bankruptcy. The size of the agent(s) in difficulty and the adverse conditions of the money market may generate a systemic risk; to avoid such a situation the central bank usually intervenes, thus ensuring orderly conditions in the market by supplying liquidity. Not only unexpected, or commotion-laden, situations will impel the central bank to act; some current capital markets sale techniques such as stop-loss sales or portfolio insurance, if generalised, need a liquidity supply which moves against the trend in order to be successful; in such a way one can avoid the tail spin of ever lower stock prices and ever more selling orders. *Per incidens*, it may be recalled that the launch and development of the telematic secondary market in government securities in Italy was facilitated by market makers with banking affiliations being able to refinance themselves with the Banca d'Italia through repurchase agreements subject to time and amount limits (an instance of ordinary CLR).

Given that the correct working of the capital markets is strongly dependent on liquidity, it is worth examining how the role of the central bank is spread out in the payments system. Continuous settlement, subordinating the payments to the existence of funds, eliminates the credit risk but slows the process of completing transactions; net balances settlement is faster and more efficient but entails a credit risk in the interval between the making of payment and determination of the net balance, in case a participant in the system

does not honour his final obligations; sometimes the non-fulfilment by a participant in the clearing system, it should be noted, is not due to financial reasons but to the breakdown of his computer system. In order to effect the "closing of the business day" the central bank, directly or indirectly, must intervene with its credit, so it becomes responsible for the risk, legally or "morally".

The ECB could not but be in favour of the granting of extraordinary microeconomic CLR in these cases, despite the fact that it may consist of a large amount, unless it opts for a payments system strongly concentrated on the banks which, in turn, implies a relatively small significance of the markets in the financial structure of the Union; this seems not only to be contrary to the present trend, but also to the tradition and importance of the British and French financial systems.

As Folkerts Landau and Garber correctly conclude, the attitude of the ECB towards the banking functions of the ESCB will depend on the equilibrium that it wishes to achieve between the cost of the lender of last resort operations and the benefits derived from liquid and securitised financial markets, which are likely to reduce the cost of capital for the issuers.

### 5.3 *The Banking Supervisor*

Finally, Article 105.5 of the Treaty and Article 3.3 of the Statute recite in unison that the ESCB contributes to the smooth conduct of the policies put into practice by the competent authorities with regard to the prudential supervision of the credit institutions and the stability of the financial system. On the basis of this norm and of Article 25.1 of the Statute, the role of the ESCB would seem to be limited to that of counsellor and monitor in a sector which has continued to develop in the shadow of the central banks. Even if the Council (by unanimous decision, on the proposal of the Commission, after having consulted the ECB and with the agreement of the Parliament) can assign specific tasks to the ECB on the subject of prudential supervision over credit and financial institutions, excluding insurance companies (Article 105.6 of the Treaty and Article 25.2 of the Statute), from the awkwardness of the procedure one gathers that this norm has little, if any, chance of being applied; therefore, it seems

pointless to go into the interpretation of what should be intended by "specific task" and into that of coordination between the possible specific responsibilities of the ECB and the general ones of the supervisory authorities.

What will happen to the supervision that many central banks, from the Italian to the British one, exercise on the basis of the law of their country? Article 14.4 of the Statute provides that national central banks can exercise other functions in addition to those stated, except if the Governing Council decides, with a two-thirds majority, that these interfere with the fundamental objectives and tasks of the ESCB; such functions remain in any case outside the area of the ESCB and are exercised under the responsibility and at the risk of each central bank. Can one conclude that the discharging of banking supervision by the latter is to be left up to each state? From the systemic point of view and recalling the heated debate which took place on the subject during the preparation of the Treaty, the reply should be negative; however, since the Governing Council cannot give an *a priori* opinion and must only declare incompatibility with a qualified majority, the scales could in reality fall in favour of the affirmative proposition. Obviously, it is assumed that, in reviewing national legislation in order to render it compatible with the Treaty (Article 108), the bank supervisor will not become divorced from the central banker.

The *ratio* for a structural link between banking supervision and the central bank rests fundamentally in the banking functions of the latter: were, as a hypothesis, the interpretative and operative evolution not to leave space in the ESCB for a lender of last resort and for a guarantor of the payments system, any justification for having the central bank exercise banking supervision would disappear. Indeed, in order to assert the role of banking supervision, one usually refers to its need to know and regulate the assets, risk and liquidity profiles of the banks, in order to be able to assist them quickly in case of need. An associated argument is that of avoiding conflict between the creditor central bank and the agency in charge of supervision, responsible for evaluating the solvency and thus the ability to survive of the bank in difficulty.

Even if the statutory function of the ESCB with regard to banking supervision is minimum, the merits of centralising this function in the hands of a specialised agency to be responsible for the whole Community area should be carefully examined; indeed,

although financial activity is becoming ever more global, the supervision responsibilities are at risk of remaining fragmented, thus creating externalities to the cost of one or another national system of supervision (Vives *et al.*, 1991). However, centralisation at the Community level increases the need for collaboration with the ESCB, in so far as the problems of solvency, which are the competence of the centralised agency, are not distinguishable more often than not from those of liquidity, which must always be referred to the ESCB.

## 6. Conclusions

What conclusions must be deduced from this long *excursus* into the themes which are the subject of the Treaty to be ratified with reference to the ECB and the ESCB? As has been seen, the institutional aspects of Monetary Union cannot avoid being influenced by the likely enlargement of the Community to many other countries; furthermore, the functioning of the EMU will necessarily interact with the reinforcement of Community powers in the social domain, their consolidation in the new areas of foreign policy and defence, the emerging cooperation in the sectors of justice and internal security. Any forecast on the direction of the developments would be overambitious at this point; however, the understanding of the crossroads to be encountered is fundamental in order to avoid setting out on blind alleys, or others which turn on themselves and lead inexorably back to the start.

On the monetary function and on the ECB and ESCB independence which must guarantee it, a good monetarist could not but be happy reading what was approved at Maastricht; it is true that an automatic rule of monetary creation was not fixed, but the indication of the single objective of price stability and the principle of political non-interference in its determination seem to consolidate in an international act the idea that it is mistaken to try to influence economic conditions by means of monetary instruments. Because of the long and variable lags through which monetary action affects productive activity, monetary policy instruments tend to lose potency and certainly credibility. It must not be forgotten, however, that even if there is only one single declared objective, its definition is not in the

Treaty, which leaves space for conflicts of interests but also room for manoeuvre.

On the other hand, even the Bundesbank, which constituted the model of the Community construction, cannot be accused of having pursued the final objective at all costs. It is true that, to protect its freedom of movement, the Bundesbank was against establishing the EMS, which was imposed by the political authority, but it cannot be questioned that the German central bank has accepted the EMS, after having found it to be fertile ground for engaging most of the European countries, not only those of the Community, in the fight against inflation. Can it be held that its former aversion to the EMS, and the effort that it now makes to bring inflation back within the narrow limits which built its reputation and credibility, will make the German central bank be even more lukewarm towards Monetary Union? Not necessarily, in the author's view. Precisely the events of German monetary unification and of the formation of the EMS show that in Germany the political authority, on subjects of constitutional bearing and foreign policy, prevails over the monetary authority. Therefore, it is wholly plausible to state that the Bundesbank may become a strong supporter of a short transition to the Third Phase; since it is no longer able to manoeuvre its exchange rate with respect to the rest of the Community area, it cannot ward off inflation that such an exchange rate structure (adjustable in theory, but in practice fixed over the last five years) exports towards Germany. Obviously, this would only be possible if the Bundesbank were convinced that the Treaty and the Statute approved at Maastricht guarantee it no less actual power in Europe than that which it now wields... If the direction to be followed and the stages to be reached have been clearly defined, the speed – a result of various forces – is not to be taken at all for granted.

Returning to the main point of our considerations about the fundamental function – the maintenance of price stability – as well as the ancillary ones of the ECB and the ESCB, it must be admitted that the uncertainty about their actual dimensions does not contribute to clarifying the constitution passed at Maastricht. On the one hand, the imposition of a minimum central bank, almost an "office for monetary policy" (Perez, 1991), has not managed to avoid the shadowy areas which later international acts should reduce, if interpretation and practice were not enough. On the other, the limited range of exceptions to the principle "one institution, one objective", and the many



questions with no clear replies, do not make the ECB and ESCB scheme appear as fully developed; such a scheme will start its operative life only in 1997, if not later, with the final passage to the Third Phase. But will the evolution be along the lines of over-shadowing the badly-defined banking functions and letting monetary responsibility shine, or else strengthening them, thus making for the re-emergence of complexity in the actions of the ECB and the ESCB and, indirectly, of plurality in their objectives?

## 7. Postil on Italy

At the end of a long dissertation on a structural transformation which will become fully operative on the dates planned not necessarily for all the members of the EMS, one is bound to ask: is the transition to the Third Phase realistic for a country like Italy? Above all, even if it were possible, is it advisable? It is known that on the basis of Article 109J of the Treaty, each member state must satisfy four criteria by the end of 1996 or 1998:

*a)* the achievement of a high degree of price stability, defined in the relevant Protocol as a divergence of no more than 1.5 percentage points, in the year preceding the scrutiny, from (*rectius*: from the average of) the three member states which have achieved the best results in terms of the stability of consumer prices, taking account of the differences in the national definitions of the indices;

*b)* the sustainability of public finance imbalances, which is presumed unless there has been a declaration of an excessive public deficit by the Council (of Ministers) according to Article 104C.6 of the Treaty to which we shall return;

*c)* the observance of the normal EMS margins of fluctuation for at least two years, without serious tensions and without having devalued the central exchange rate on its own initiative;

*d)* the long-lasting character of the convergence, in the year preceding the scrutiny, as reflected in the average interest rate, nominal and long-term, which shall not exceed by more than two percentage points the corresponding rate (*rectius*: average rate) of the three countries with the best results as regards price stability.

Taking into account the results achieved by means of monetary policy and above all exchange rate policy in the last few years, and since this is not the occasion for an exercise in (questionable) forecasting, it does not seem an excessive risk to assume that conditions *a)*, *c)* and *d)* are attainable. In effect, to meet them it is required to lower inflation by another couple of points, not an easy task in the highly rigid Italian context, but neither an impossible one with a suitable wage and competition policy; the other two requisites will become "automatically" satisfied by controlling the rhythm of price increases. That leaves point *b)*, concerning public finances: it is clear that in the light of Article 104C and the annexed Protocol, Italy would not be entitled to participate from the beginning in the Third Phase of the EMU unless its public debt had managed to decrease to close to 60 per cent of GNP by the end of 1996 or 1998, which is utterly unlikely, and the public deficit were near three per cent of the GNP at the same date, only achievable with drastic cuts in expenditure. Given the structure of the Italian public debt – short term or indexed to short-term interest rates – it is true that a further decrease in inflation would reduce its cost, thus favouring the correction of the estimated expenditure; however, one must consider that the interest rate on the public debt of each country in the EMU will increasingly reflect the credit risk which is greater, the higher is the indebtedness (Bishop, 1991).

Article 109J, however, does not refer to Article 104C.2 but to Article 104C.6, which signifies that even though a member state may be in violation of its specific obligations regarding public finance, as a consequence of the global evolution or the non-achievement of the *quorum*, it may be admitted to the Third Phase. It would be very sad for Italy if its admission were determined by a procedural subterfuge! However, this "danger" is quite remote, since the Treaty (Article R) will come into effect on January 1, 1993, always assuming that all the ratification instruments have been deposited; that is to say, Article 104C.2 could be applied to Italy at any time in the four-year period 1993-1996, also because Article 2 of the Protocol on the convergence criteria states that when each member state is scrutinised for its transition to the Third Phase, a decision must be taken about its excessive deficit. As the *Financial Times* (March 30, 1992) commented, appealing for a hard line on convergence, "It is not in Italy's interests for it to be offered a soft option".

Given that one should regard Italy's transition to the Third Phase with worried pessimism, can it be held to be advisable? It depends whether one looks at the problem from Italy's point of view, or that of the more orderly countries of the Community. It is clear that Italy needs shock therapy, which it will get sooner or later; in any case, if Italian politicians continue to demonstrate optimism that has no foundation, the disappearance of monetary sovereignty, rendered irrevocable and highly visible by the single currency, will remove any illusion of easy solutions. For the more virtuous members of the Community, however, the admission of a country without the necessary requisites laid down by the Treaty weakens the credibility of the latter and, above all, does not prepare the conditions for making the task of managing a single currency less laborious, precisely because the public finances of the member states are healthy. This attitude cannot but be shared by all those who believe in the achievement of European unity. Indeed, if any criticism should be raised, it is not about Article 109J and the annexed Protocol on the criteria of convergence, but possibly against Article 104C which decrees "for ever" while monetary policy cannot be used to pursue anticyclical objectives or to neutralise shocks which have a different impact on the regions (Begg *et al.*, 1991); indeed, the constraints imposed do not make fiscal policy useless, but render weaker and more rigid the economic policy instrumentation of the European Community, the greatest economic power to enter the 21st century.

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